Corporate Governance, Voting and Stewardship, April – June 2012

This note comments on corporate governance issues and provides examples of corporate governance and engagement activity by the UK office of Schroders during the period April to June 2012. The examples cover activity linked to voting and engagement with companies outside day-to-day investment contact.

General approach to engagement and corporate governance

As in previous reports, the following paragraphs illustrate our approach to engagement with companies and our views regarding disclosure of that engagement.

The aim of all engagement on governance by Schroders is to enhance the value of the funds managed for clients. To achieve this aim, we find it essential to take a pragmatic approach in terms of how we deal with companies and how we report our engagement with them. We believe that additional value is created by engaging with and if necessary encouraging change at companies but recognise asset allocation and selection of individual stocks may have a greater impact on the returns in a client's portfolio.

Our reports on voting, engagement and corporate governance are necessarily brief and generally hide the names of the companies involved and only provide a sample of activity. We believe it necessary to avoid conducting public discussions if change might involve a climbdown by the company: it is generally preferable for companies (indeed, for any person) to accept and agree with change rather than to have it forced upon them. Publicising concerns about a director or the board of an organisation will be destabilising to the company, may damage our ability to conduct constructive discussions with any company, may damage the value of a company and may discourage talented individuals from becoming members of listed company boards. Further, particularly where Schroders manages shares comprising a significant proportion of a company's share capital, it is not in clients' interests to disclose details of the engagement Schroders must inevitably have with these companies.

There are occasions, however, where it is appropriate to reveal contact with companies, particularly in high profile cases or where we have taken a stance that requires explanation and justification.

Schroders also produces reports on engagement with companies on corporate and social responsibility. These reports are available from client directors or our SRI specialists.

Corporate Governance Policy

The Schroders corporate governance policy and our statement regarding our compliance with the UK Stewardship Code are both available on the Schroders' Internet site.

Selection of Company Contacts

Company A

We had been engaging with a company over the last year regarding board membership (reported in Q1, 2012). Another large shareholder had asked the company to appoint a new non-executive director. The shareholder agreed with our suggestion that the board would benefit from 2 new non-executives. The company agreed to the appointments. We also considered that the company would benefit from a change of chairman.

The other shareholder was pressing for the company to be sold and considered that a change of chairman would interrupt this process. We agreed that given the sector and the company's position, the logical outcome would be that the company would benefit from being part of a larger organisation. We were concerned, however, that the company should not be sold immediately because there were some areas where the company could improve and therefore increase value for shareholders when a sale occurred. However, during the quarter, a bid appeared. We refused to sign an irrevocable commitment to accept the offer and hope that another bid may arise. In governance terms, the outcome is disappointing because a longer term approach would, our fund managers believe, have benefitted shareholders, particularly if the company had appointed a new chairman some months ago.

Company B: Tesco

CtW, a group representing US trade unions, has been campaigning against Tesco's operations in the US. It has lobbied shareholders and drawn attention to operational shortcomings in the Tesco US business. They intended to propose an amendment to the resolution to adopt the report and accounts: the resolution would have amended the report and accounts to be more critical in references to the US business.

We have questioned the US operations for some years, drawing attention to the considerable sums invested in the US for a return which appears to be ever further away. We had also objected to the payment of bonuses in 2010 for the US operations notwithstanding poor performance. The US is also something we have discussed with the former chairman and the new (appointed December 2011) chairman of Tesco in addition to other business and operational issues at Tesco.

Having discussed the US with the new chairman and since the chairman is only recently appointed to a challenging role, we did not feel it was constructive to challenge the board with a shareholder ambush at the AGM. The chairman is fully aware of the US and other pressing issues facing Tesco. He deserves time to consider and oversee the implementation of an appropriate response.

Further, the method of raising a shareholder vote on an amendment at the AGM, on which only those attending or directly represented at the AGM may vote, is a technical method to force a board into submission without all shareholders having had the opportunity to consider any changes to a resolution in detail.

Accordingly, we voted for the board at the AGM but wrote to the company regarding the shareholding requirements/guidelines for executive directors. One director, in particular, had been selling shares.

At the AGM, the board received 99.91% of shares voted in favour of the report and account.

Company C

We reported in Q1 (Company C, Q1 2012 report) that a company we supported had met some opposition from other shareholders on pay proposals. Objections included that the CEO's salary was too high given the market capitalisation of the company. The company has a low P/E but continues to make a profit. We held a number of discussions with the company and other shareholders. We subsequently attended a joint meeting with other shareholders. As in our discussions with the board, we noted that the objections were not simply to the company's pay but that other shareholders opposed the company's CEO: we considered it appropriate for that issue to be addressed head-on rather than using a discussion about pay as a proxy for the underlying issue.

The company made acceptable changes to the pay arrangements. Other shareholders, however, continued to object and the remuneration report received a high number of votes against although the resolution was passed. The CEO announced their resignation and the company is now seeking a successor.

We continue to support the board and will continue to engage regarding performance.

Company D: Barclays

The events following the announcement of LIBOR rigging by Barclays (amongst others) occurred after the end of Quarter 2 and will therefore be covered in our next report.

During Quarter 2, we did engage with the company as part of the regular meetings we have with the chairman and in connection with the vote on the remuneration report at the April AGM.

Issues discussed with the chairman included achieving an adequate return, the bonus pool, dealing with the tax authorities and a concern that the Barclays reporting included an element of 'smoke and mirrors'.

In 2011, we had voted against the remuneration report and an LTIP because the remuneration arrangements were not tied to appropriate performance conditions and returns to shareholders. Shortly before the 2012 AGM, we reviewed how we would vote.

We met the company and discussed our concerns on the business generally. These included the necessity to achieve return on equity targets, the staff:/shareholder reward ratio (particularly that the returns for shareholders were unduly low relative to employee rewards) and that the Barclays reporting was unduly complex and aggressive. We considered that some of the actions taken by Bob Diamond as chief executive deserved support: the changes to benefit from the universal banking model, for example. We were also concerned that defeating Barclays on pay at the AGM would bring an undue level of criticism that was not justified. Accordingly, on the basis of the undue criticism that would attach to a defeat on the pay vote and subject to the assurances that the shareholder:staff ratio would be improved together with improvements in reporting, we voted for the resolutions at the AGM.

The AGM was a month before the Barclays involvement in the LIBOR rigging was announced.

Company E

The company consulted us - and other shareholders - regarding pay arrangements for the executives. The company was not increasing the quantum of the rewards available but was changing the performance conditions governing release of shares in the long term incentive plan (LTIP). The new performance conditions were based on a balanced scorecard of measures, as opposed to the more traditional EPS and TSR targets. We opposed the new targets. We understand and accept the use of balanced scorecards in annual bonus plans because of the ability to refine and review the metrics annually and as a method of aligning the remuneration with some of the factors a board should take into account in reviewing the performance and retention of an individual. Long term incentive schemes are the one area of executive pay where shareholder approval is required - albeit periodically - and awards are generally released in the form of shares, often newly issued shares. Therefore, LTIPs and share option schemes should be subject to performance conditions which are closely aligned to the returns available to shareholders.

The measures this company will use include a significant proportion based on non-financial targets. We understand why the company is proposing them but are concerned that i) they are not sufficiently aligned with ultimate performance of the business - they measure inputs, not output ii) they dis-incentivise executives from reviewing and if necessary changing strategy iii) if the wrong measures are used, they may reward directors for destroying value iv) executives may achieve some targets and therefore receive rewards notwithstanding that the business generally is under-performing.

After some pressure from shareholders, the company made a number of adjustments which improved the link between rewards and returns to shareholders but not to a level we required. However, the company receives a certain amount of press coverage. The company was concerned that a negative vote on remuneration would lead to an undue amount of public hostility. We agreed: we objected to the pay arrangements but consider the company's leading executives are an asset and would not deserve the press criticism to which they and the board would be subjected. Accordingly, we voted for the pay arrangements at the AGM but made clear to the chairman that we objected to the substance of the pay proposals and did not wish to provide any ammunition for special interest groups and the press to attack the company.

We will continue discussions with the company on this and have on-going discussions regarding the company's strategy.

Company F

We have reported on-going engagement with a company which led to the departure of the current CEO (Company F, Q1 2012 report). We were subsequently contacted by the company prior to the announcement of a new CEO. We agreed with the appointment.

Company G

We met the chairman of a large company. The meeting followed several years of engagement with the company. The changes made by the company during this time have been significant and positive. The chairman reinforced this change to a higher performance, fast moving culture, overseeing the appointment of a chief executive who has continued the improvement. We discussed the speed of progress and the company's strategy and operational performance. It was a positive meeting and confirmed that we were justified in supporting the company.

Company H

We met the recently appointed chair of a Mid-250 company. The chair sought our views on the business. Subjects covered included the CEO succession (we support the current CEO but the length of his tenure suggests there may be a risk he would soon seek a new role) and the future of the company, including whether the best outcome for shareholders in the long run would be a takeover of the company given the history and nature of the sector.

Company I

During a regular 1:1 meeting with the CEO and finance director of a retail company, our analyst asked if the management team were retailers or investors, both individuals glared back saying “we are investors”. It was a model example which we wish other companies could have seen. The behaviour of the company’s management and board is entirely consistent with that view. The company, despite being a retailer in a difficult environment, has significantly outperformed the market.

Company J

We met the incoming chairman of a company and asked about certain business issues, in particular linked to acquisitions undertaken by the company. It was therefore disappointing when the company revealed a profit warning a few weeks later. We will be continuing to engage with the company, if only to ensure the board understands its current position and the business and is not complacent.

Company K: Xstrata/Glencore

Our opposition to the terms of the Glencore-Xstrata merger have been reported previously and received coverage in the press. During the quarter, we met Sir John Bond, the Xstrata chairman. We continue to oppose the transaction on the terms originally proposed. During the quarter, we also learnt of the remuneration arrangements for the executives after the merger. The pay arrangements are unacceptable: we recognise the need to provide high rewards for successful executives. The Xstrata/Glencore payments will, however, reward the executives for a deal which transfers value away from Xstrata shareholders and which (as originally announced) would provide the rewards irrespective of performance. The companies subsequently announced some degree of conditionality for the rewards but there remains a significant difference, in our view, between the level of reward for executives and the returns that will be created (if any) for shareholders.

The transaction has been postponed to allow the new performance conditions attaching to the executive remuneration to be put to shareholders. It will also permit time for Xstrata to attempt to gain support from shareholders opposing the transaction.

In connection with our concern with the merger, at Xstrata's AGM in May, we voted against several directors and the power of the company to issue shares.

Company L

We met the chairman of a company which had announced the chief executive is due to retire. We discussed the criteria for the appointment of the new CEO and potential internal candidates. The company has changed in a number of positive

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aspects recently, mainly driven by one of the internal candidates. We noted, in particular, greater clarity in the company's disclosures and better communication of a strategy.

We were content that the candidate we were keen for the company to retain was subsequently appointed as CEO.

Company M

We met the chairman of a company regarding the long term future of a company. It is a company widely regarded as ultimately being part of a larger organisation (or organisations). We had some concerns that the chairman may be minded to ignore offers with an aim of keeping the company independent. The chairman confirmed that if an appropriate offer materialised, he and the board would consider it and accept it if it was at an appropriate value. His assurances were welcome. Whilst it may be sad to see a company taken over, it can provide significant benefits for shareholders, executives and employees by the company becoming part of a stronger (financially and geographically) organisation.

Company N

We met the chairman of a company where performance had been disappointing. The chairman, disappointingly, strongly defended the chief executive when we questioned the poor performance of the business. The value of the business has declined significantly during the chief executive's tenure, partly through damaging acquisitions.

The views of the chairman in defending the chief executive and the degree of complacency undermined our support for him. Accordingly, we voted against the chairman at the company's AGM.

We also voted against the remuneration report because there was a substantial difference between the rewards for executives and the performance of the company. The remuneration report was defeated.

Company O

We were contacted by the chair of a company and were asked to be made insiders. Since it would be for a limited period, we agreed. The chair subsequently explained that the company was due to announce that the company's chief executive would be leaving and replaced by an internal appointment. The company was sorry to be losing the chief executive, who had an offer of a post at another company. We asked to be given a few moment to consider the proposed new chief executive – it allowed an element of due diligence. We were then able to confirm we agreed with the new appointment.

The reason we were taken inside was because the departing chief executive was highly rated and it was anticipated that announcement of their departure would cause a share price movement. Fortunately, the appointment of a successor in a prompt and orderly manner appears to have calmed the reaction on announcement.

Company P

A company's share scheme for directors and senior executives releases share awards partly on the level of EPS performance of the company. However, the impact of share buy-backs are excluded from the EPS calculation. Whilst this meets the guidelines and policies of less-objective shareholders and advisers, we believe that allowing executives to benefit from an increase in EPS arising from a share buy-back is important.

When a company has sufficient cash and financial strength to consider buying back its shares, it should do so when the market price of the company's shares is at a level when the buy-back would have the effect of increasing earnings per share and return on capital. We have seen many companies where the market valuation of the company's shares has meant that the most efficient return the company can achieve is to buy-back shares. Whilst this may appear to be simply financial engineering and/or an accounting trick, it is not. We saw one company this year where it could have achieved a return of more than 40% if it had bought the company's own shares. Accompanied by low execution risk, the return would have been at a level that would be difficult to achieve in its business operations. The benefits of a buy-back also include providing a use for potentially excess cash: we have seen too many examples of companies using funds to make value-destroying acquisitions.

We discussed the matter with the company's chair and the chair of the remuneration committee. They explained i) the policy of excluding the effect of buy-backs would be not be applied in future bonuses or LTIP awards; ii) the board wanted to focus on earnings growth – the numerator – rather than potentially concentrating on the denominator (number of shares in issue). Based on those explanations, we were delighted to confirm our support for the board and the remuneration policy at the company's recent AGM.

Other issues

A fund manager from Schroders appeared, with 2 fund managers from other firms, before a Treasury Select Committee at the House of Commons regarding the inquiry by the Committee into the disposal of the UK Government's stakes in Royal Bank of Scotland and Lloyds Banking Group. There was also further communication with the Committee's support staff.